Italy

Country note, July 2019

Key messages:

- **The PBO endorsed the macroeconomic policy scenario of the 2019 SP.**
- **The 2019 SP aims at declining deficit and debt ratios in 2020-2022, providing limited information on how to reach the targets.**
- **The PBO flagged an inadequate fiscal adjustment for 2018 and a risk of significant deviation for 2019.**
- **The PBO underlined the non compliance with the debt reduction rule in 2018 and in the forecast for 2019-2020.**
- **In June, the Commission concluded that a debt-based EDP was warranted but subsequently did not propose the opening of an EDP to the Council, as the Government adopted new corrective measures for 2019.**

Macroeconomic outlook

The PBO endorsed the macroeconomic policy scenario of the 2019 SP, highlighting however the risks associated with the international context (a slowdown of the Chinese economy, uncertainty about Brexit, intensification of geopolitical tensions, increasing financial imbalances and investors' risk aversion), the domestic situation (weak economic activity) and the high degree of uncertainty that characterises national fiscal policy. The 2019 SP forecasts real GDP growth at 0.2 percent in 2019 and 0.8 percent in 2020-2022, which is within the range of PBO estimates (Chart 1).

Short-term fiscal outlook

According to the 2019 SP, the government deficit would have increased from 2.1 percent of GDP in 2018 to 2.4 in 2019. The debt/GDP ratio would have slightly increased from 132.2 percent in 2018 to 132.6 in 2019. However, on July 1st the Government adopted its mid-year budget for 2019 and a new decree-law, with corrections implying a revision of the deficit at around 2 percent of GDP.

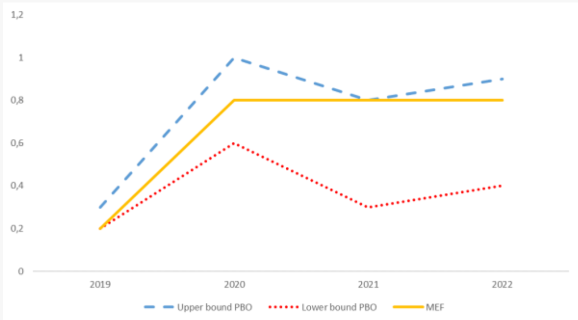
Medium-term fiscal outlook

The PBO emphasised that the budget package set out in the SP resembles a "complex puzzle" with limited information provided by the government, which will require a clear identification of policy priorities. The policy scenario factors in the increase in VAT rates legislated as "safeguard clauses" (worth €23.1 billion in 2020 and an additional €5.7 billion from 2021) but that the Government intends, at least partially, to repeal. In the SP, the path of the deficit/GDP ratio is declining: 2.1 percent in 2020, 1.8 in 2021, and 1.5 in 2022. This is achieved through higher primary surpluses (Chart 2). Similarly, the debt/GDP ratio is also declining: 131.3 percent in 2020, 130.2 in 2021 and 128.9 in 2022. The resources needed to achieve these policy objectives are based on the following main pillars: the already mentioned "activation" of the "safeguard clauses" involving increases in indirect taxes, the reduction and rationalisation of tax expenditures, measures to counteract tax evasion, a spending review and privatisation receipts. Each of these approaches has critical aspects, which were flagged by the PBO. In particular, the PBO underlined that the public finance scenario is exposed to the risk of total or partial unfeasibility of the privatisation programme, which is important for the planned debt reduction.

Fiscal framework and national fiscal rules

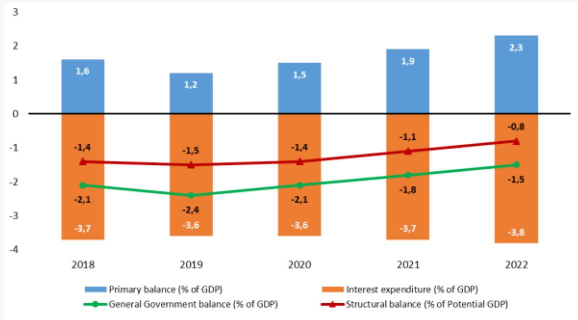
The 2019 SP envisages a slightly more ambitious structural adjustment path towards the MTO compared to that of December 2018, also thanks to the already-mentioned VAT hikes in 2020-2021. Nonetheless, according to the PBO, Italy's structural adjustment in 2018 is zero and is thus inadequate, as it is not in line with the required adjustment of 0.3 percent of GDP, which was halved due to the application of the "margin of appreciation" by the European Commission. In addition, the growth in the expenditure aggregate is greater than the benchmark, confirming the inadequate adjustment. According to the PBO, the SP provides only a limited explanation of the estimated deviation in 2018 and does not indicate whether the 2020 policy objectives already correct the deviation. Based on the SP, the PBO flagged for 2019 a risk of significant deviation, even considering as granted the flexibility requested by the Government. Moreover there is no compliance with the numerical debt reduction rule either in 2018 or in the forecast period, despite the decline in the debt/GDP ratio. According to PBO simulations, without the VAT hikes in 2020-2021 and the privatisation proceeds and considering the need to finance some spending programmes which are not in the Government's baseline ("no-policy change"), the debt ratio would be continuously rising (Chart 3). On June 5th the European Commission prepared a new Article 126(3) Report which concluded that the 2018 debt criterion should be considered as not complied with, and that a debt-based EDP was thus warranted. However, following the measures adopted by the Government on July 1st, the Commission on July 2nd concluded not to propose the opening of an EDP to the Council at this stage.

Chart 1: Real GDP Growth [% GDP]



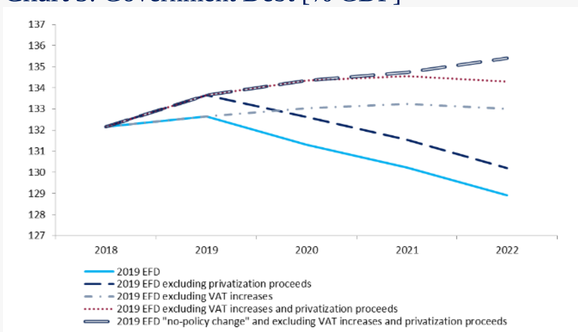
Source: EFD and PBO calculations and estimates.

Chart 2: Government Balance and Interest [% GDP]



Source: EFD and PBO calculations.

Chart 3: Government Debt [% GDP]



Source: EFD and PBO calculations and estimates.

Key indicators

		2017	2018	2019f	2020f	2021f	2022f
Real GDP growth	[% change]	1,7	0,9	0,2	0,8	0,8	0,8
GDP Deflator	[% change]	0,5	0,8	1,0	2,0	1,8	1,6
Output Gap	[% Pot-GDP]	-1,8	-1,5	-1,7	-1,6	-1,6	-1,6
GG balance	[% GDP]	-2,4	-2,1	-2,4	-2,1	-1,8	-1,5
Primary balance	[% GDP]	1,4	1,6	1,2	1,5	1,9	2,3
Structural balance	[% GDP]	-1,4	-1,4	-1,5	-1,4	-1,1	-0,8
GG debt	[% GDP]	131,2	131,7	130,7	129,2	128,2	128,2
Adjusted nominal GG expenditure growth net one-off	[% change]	1,4	1,8	1,7	0,5	0,9	1,0
Discretionary revenue measures net one-off	[% GDP]	-0,2	0,4	0,2	0,9	0,3	0,2

Source: 2019 Stability Programme, policy forecast, Economic and Financial Document (EFD), Ministry of Economy and Finance, April 2019.

f = forecast

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